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DIRECTORATE OF INTELLIGENCE

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Special Report

Central American Economic Integration: Phase II

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CENTRAL AMERICAN ECONOMIC INTEGRATION: PHASE II

The Central American Common Market (CACM), now in its ninth year, has reached a crossroads. It has behind it an impressive record of successes and—at a time when the Arab Common Market is stagnant, the Latin American Free Trade Association and the Caribbean Free Trade Area are bogged down, and several African efforts at economic integration are still-born—has proved to be one of the most successful economic integration movements outside of Europe. There are, nevertheless, clear indications that the Common Market is going through a perioc of flux, even of crisis, as the five member countries attempt to come to grips with a number of difficult political problems that previously had been ignored or circumvented. There are demands that existing agreements be implemented and that the pace of integration be increased. It is also becoming clear that continued high rates of regional economic growth and a solution of the area's revenue and balance of payments problems will require more fundamental changes, perhaps even a restructuring of the Common Market.

The problem of greatest immediacy, however, is that of balanced development. The less developed states, notably Nicaragua and Honduras, have insisted on preferential treatment to ensure that their gains from integration would be as significant as those of the other member states. While the principle of balanced development has been accepted, disagreements as to its application underlie much of the argument over specific issues and are a direct cause of the present crisis resulting from Nicaragua's unilateral imposition of a tax on intraregional trade, in violation of existing agreements.

BACKGROUND

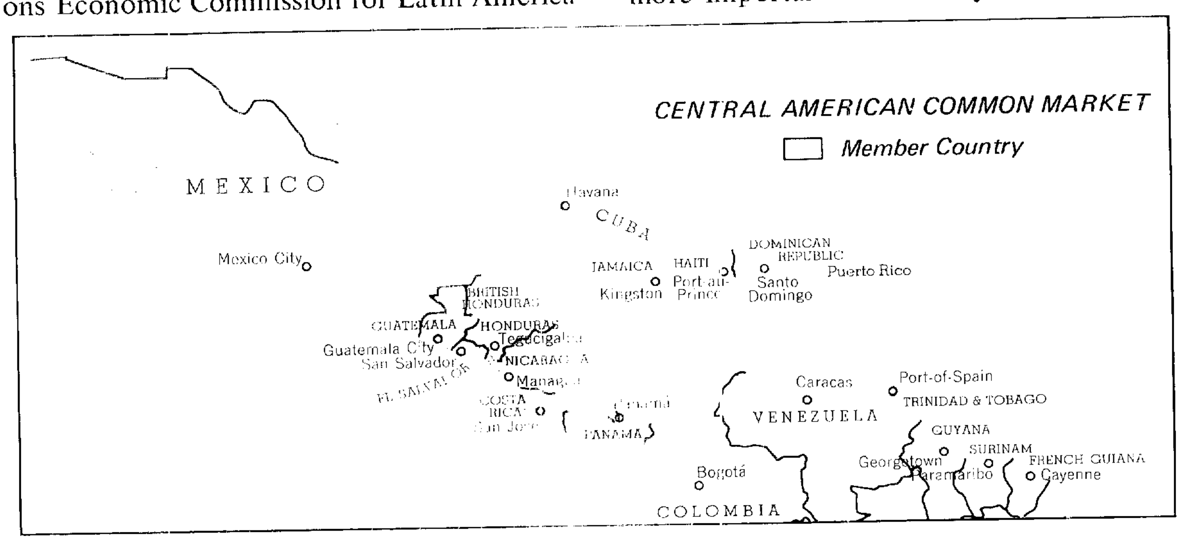
Although the concept of regional integration is for the most part a post-World War II development, the urge toward Central American unity had more historical roots. The five Central American states were briefly joined together as part of the United Provinces of Central America after securing their independence from Spain early in the 19th century. This union foundered within 15 years, but the idea of a single Central American state, though it never proved feasible, remained a part of the area's political mythology.

Movement toward regional integration began in 1951 when the Central American leaders began to negotiate bilateral free trade agreements. This move was supplemented by the formation of the Organization of Central American States (ODECA), designed to promote the political and economic integration of the area. While ODECA has a formal—though rather imprecise—role in economic integration, in practice it has been of minimal importance. Of more consequence was the request, also made in 1951, that the United Nations Economic Commission for Latin America (ECLA) study the question of Central American economic integration.

The general thrust of the ECLA analysis was that the world market for agricultural products and raw materials, upon which the Central American economies depended, would grow slowly. Thus, if economic growth were to be promoted, industries must be developed. The suggested direction of industrial development was import substitution—that is, domestic production of goods formerly imported. Since the size of each individual national market was too small to permit the efficient operation of large-scale modern industry, however, regional integration was recommended.

Central American leaders favored this line of argument. They were well aware of their countries' vulnerability to fluctuations in the world price of agricultural and raw material exports and were easily convinced of the discouraging long-term trend for these products. In addition, there was a vast faith in industrialization and enthusiasm for such a shift.

There was, however, another and perhaps more important reason why the ECLA approach



seemed to hold such promise. It did not seek quick basic structural changes and it did not challenge vested interests. In short, if the proposals made economic sense, they were also politically feasible. Though export agriculture was the mainstay of the Central American economies, the integration approach ignored export agriculture and thereby avoided the politically explosive issues of land tenure and agrarian reform.

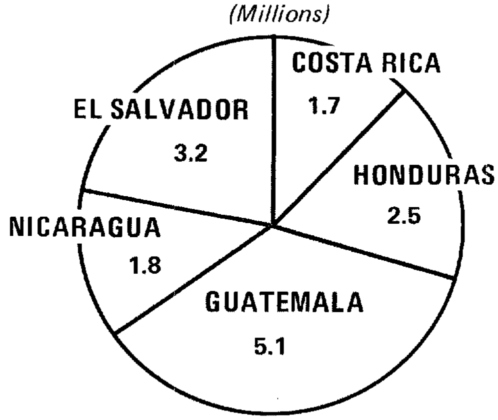
On the other hand, proposals to attract new industry and to expand existing industry could hardly fail to appeal to labor and business interests. Indeed, the very dearth of Central American industry was a positive factor. Thus, proposals to set up a particular industry in a particular country to serve the entire Central American market would not run up against the bitter opposition that would have arisen if each country had an already established industry that was being threatened by integration schemes.

Five legal documents form the backbone of the integration movement. The General Treaty sets up the Common Market and provides for free intraregional trade, and the Agreement on Equalization of Import Tariffs provides for a uniform tariff to be applied against imports from outside the Common Market area. In addition, there are three specialized instruments designed to promote industrial growth: the Charter establishing the Central American Bank for Economic Integration; the Convention on Integration Industries, which provides special benefits to designated industries set up to serve the entire market; and the Convention on Fiscal Incentives, equalizing concessions that may be offered to attract industry.

THE EARLY YEARS

The Common Market's early years were marked by impressive successes and a general feeling of optimism. Notwithstanding the gloomy thesis that demand for Central America's traditional agricultural exports would stagnate or grow very slowly over the long run, the creation of the Common Market and its early development (1960-1965) coincided with a period of

POPULATION
(Millions)



Total CACM Population 14.3 Million

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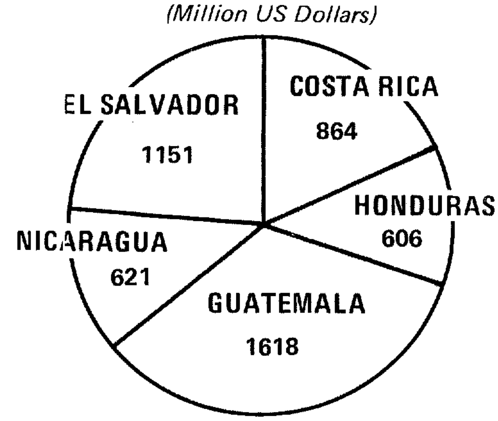
GDP *
(Million US Dollars)



*Gross Domestic Product

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impressive export growth. The considerable increase in Central American export earnings during these years stimulated the area's general economic activity. In addition, significant progress was made in eliminating intraregional tariffs, in creating a uniform external tariff, and in attracting new industry—three very important Common Market goals.

At the heart of the Common Market is the system of free trade for products of Central American origin, and in this area the most striking gains have been recorded. Currently, 95 percent of all items in the Central American tariff schedule—accounting for an estimated 98 percent of the region's commerce in terms of value—are exempt from duties or other restrictions in regional trade. An essential concomitant of free trade has been the development of uniform external tariffs, because with divergent external rates, the market countries would have found it difficult to remove internal trade barriers. Agreements have already been reached on common rates for all but 26 items—which account for only about 19 percent of the area's imports from abroad—and efforts are being made to include these items.

The larger market created by the system of free trade acted as a magnet for investment and industrial expansion. Traditional industries (food processing, beverage production, and textiles) expanded, and industries producing pulp and paper, tires, fertilizer, insecticide, cosmetics, pharmaceuticals, and other products were attracted. A measure of the success of the market can be found in the dramatic expansion of trade among the member countries. In 1960 intraregional trade was equal to only 6.4 percent of the area's total exports; by 1967 the proportion had climbed to 26 percent. In the same period, market trade with the rest of the world grew almost 58 percent.

DISCORDANT NOTES

The establishment of the Common Market represented in some ways a Central American declaration of independence from the vagaries of world commodity markets. The market was, in effect, designed to lessen dependence on export agriculture and to offset the uncertainty of export earnings. It is ironic, however, that the export situation has in large measure colored attitudes toward the market.

It was more than coincidental that the rapid progress of integration occurred during a period of export growth and rapidly increasing export earnings. Indeed, while the economic pie was growing rapidly, concern for its precise division was kept low key, and confidence in the technical, economic solution to development problems was unchecked. Central American presidents were content to follow the advice of their ministers of economy and did not seem to understand or concern themselves with the long-term political or even economic implications of the various agreements being signed.

Beginning in 1966, however, as balance of payments problems grew, as export prices tended to stagnate or even decline, and as government revenues failed to rise as rapidly as needed expenditures, the political questions previously swept under the table began demanding attention. The prior conviction that integration meant development came into question as Honduran and Nicaraguan leaders increasingly began to ask whether their development was not in fact being hampered by membership in the Common Market.

In a sense, progress toward integration had worsened rather than eased the usual problems

DISTRIBUTION OF CENTRAL AMERICAN BANK LOANS 1960-1968

	Number of Loans	Amount of Loans	Percent of Total
COSTA RICA	30	US $ 23,705,669	16.3
EL SALVADOR	40	28,228,876	19.3
GUATEMALA	37	27,074,226	18.6
HONDURAS	54	34,154,833	23.4
NICARAGUA	37	32,642,134	22.4

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associated with inadequate export levels. Increased industrialization created a growing need for equipment and raw material imports that could not be so easily cut without causing even greater economic difficulties, including the slowing down of production and the laying off of workers.

If industrialization tended to aggravate balance-of-payments problems, to cause imports to rise more rapidly than exports, it also tended to increase government revenue problems. Social and economic development programs swelled government expenditures, while revenue collection, already strait-jacketed by an antiquated tax system, was kept in check because of the increasing quantity of duty-free intraregional trade and the fiscal incentives granted to industry.

In early 1968 the growing concern about the balance of payments disequilibria led to the consideration of an import surcharge and tax plan which became known as the San Jose Protocol. This protocol, signed in June 1968, provides for a 30-percent tariff surcharge on imports from outside the region and allows the levying of consumer taxes on a number of nonessential items. Internal political problems in Costa Rica and bickering between El Salvador and Honduras delayed ratification and deposit of this measure.

Although the slowdown in economic growth that created balance-of-payments and revenue problems was the precipitating factor in the series of controversies after 1965, much of the acrimony has stemmed from the issue of balanced development. This principle, which had been accepted as one of the operating precepts of the market, expresses a commitment to give special encouragement to investment in the countries that had made the least progress in the development of manufacturing.

Balanced development was given recognition in the 1962 Fiscal Incentives Convention and was written into the Charter of the Central American Bank. Under the terms of the convention, both Honduras and Nicaragua were given the temporary right to grant additional incentives to attract industry, while the bank granted them a larger percentage of loan money than was given to the three other member states. Nevertheless, as the market developed, the expected differences in resources and efficiency among the member states began to stand out more and more prominently. By 1966 it was clear that the area was splitting into the gainers and the losers from integration—those who had favorable balances of trade within the market, and those who purchased more than they sold. The losers were Honduras and Nicaragua, and they made it clear that they were irritated by the way the principle of balanced development was being implemented.

Honduras was particularly disturbed by the implications of the Fiscal Incentives Agreement and refused to ratify it. The Honduran argument was that since industry is naturally attracted to the developed areas where skilled labor and more adequate transportation and power facilities are available, Honduras would be drastically handicapped by any agreement that equalized the incentives that could be offered to attract industry. The very limited concessions Honduras had originally been granted were deemed totally inadequate, and the continued failure of the more developed countries to grant additional concessions was seen as clear evidence of disregard for the principle of balanced development. Only after four years of repeated complaints were further concessions finally granted.

Under the terms of the Managua Protocol signed in September 1966, Honduras received the right to increase its fiscal incentives to industry up to 20 percent more than the level of the other four countries. The signing of the Managua Protocol did not, however, resolve the issue because El Salvador refused to deposit ratification of the protocol until mid-March 1969, and Honduras in turn refused to deposit ratification of the 1962 Fiscal Incentives Convention.

Nicaragua, whose industry also seems unable to compete effectively within the Common Market, climbed onto the Honduras bandwagon at the last minute and at the 1966 Managua meeting also demanded additional benefits. Nicaragua was less successful in gaining concessions, however. After some wrangling the five ministers of economy provisionally agreed to extend to Nicaragua half of what had been conceded to Honduras, but this recommendation was then passed to ECLA for study; it has languished there ever since.

THE PRESENT CRISIS

By 1968 it had become clear that Nicaraguan President Somoza was taking a more jaundiced view of Common Market developments. Nothing had occurred to change his long-standing view that while Nicaragua had done more than its share to promote economic integration—it had quickly ratified the various protocols, for example—it had not benefited enough in return. Indeed, Somoza was prone to blame many of his country's economic problems on unfair trading practices of the other Common Market countries, and he alleged that their failure to implement all of the pending protocols was impeding Nicaraguan economic growth.

Thus, with the Convention on Fiscal Incentives stalemated six years after it had been signed, with El Salvador unwilling to deposit ratification of the Managua Protocol to this convention, and with meager progress toward ratification of the San Juan Protocol that is designed to increase government revenues and to halt deterioration in the area's balance of payments situation, the stage was set for a crisis; only a spark was needed to set it off.

The crisis broke on 28 February when Somoza, in direct contravention of integration agreements, announced the imposition of a tax on certain imports from the other market countries.

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25X1 [redacted]

25X1 [redacted] Having previously imposed an unpopular austerity program and being unwilling to reduce further the level of public investment, Somoza opted to raise additional revenue, and to do so in such a way as to pressure his market partners to ratify, deposit, and implement all pending agreements.

The Nicaraguan action sent a shockwave through the market. The immediate reaction of the other member states was to levy an equivalent tax on Nicaraguan exports. Nevertheless, Somoza's rather crude move was successful in breaking the logjam and engendering some forward movement. On 14 March 1969 Honduras and El Salvador agreed to deposit a number of outstanding agreements including the Convention on Fiscal Incentives and the Managua and San Jose Protocols. Costa Rica also pledged its fullest efforts to ratify the San Jose Protocol. However, the measure has become an internal political issue and President Trejos has not been able to get the opposition-controlled legislature to approve the agreement.

In spite of progress, Somoza was not ready to rescind the tax, and resolve the crisis. Costa Rica's failure to act on the San Jose Protocol was not the only reason. Somoza was aware that even the full implementation of all pending agreements would not be enough to halt Nicaragua's continued balance-of-payments deficit or to increase government revenue sufficiently. Consequently, he pressed for additional concessions.

Somoza's initial bargaining position included a long list of demands. Most of these were not entirely new ideas and were merely designed to implement more fully the decisions already agreed upon. Demands in this category include the deposit of all protocols, and the creation of a tribunal to settle integration disputes.

In addition to these relatively limited measures, Somoza also indicated an interest in fundamentally restructuring the market. This would include replacing the 1960 General Treaty and the multiplicity of protocols with a single new treaty. One significant change which was particularly stressed would involve a movement away from free intraregional trade. This is the proposal for a new tax on intramarket trade to compensate for loss of revenue as a result of integration. This tax, however, would be lower than the tariff on similar products from outside the market to keep regional products competitive within the area.

Most of these measures would require a good deal of study and could not be implemented in the short run. Somoza of course realized this and was prepared to compromise far short of his demands. Nevertheless, he believed he had raised significant issues and thus, the continued success of the integration movement required that they be given serious consideration. On 21 March an agreement finally was reached at a meeting of the five Central American ministers of economy. Nicaragua pledged to convert its present tax on Central American imports into a nondiscriminatory sales tax, and the other Common Market countries agreed to lift their retaliatory tax on Nicaraguan products. Most significant from Somoza's point of view, and indeed for the future of the market was the adoption of a plan to speed the pace of integration. Although the specifics remain to be worked out, the plan contemplates action to coordinate industrial, agricultural, monetary, and infrastructure policies. It also calls for freer movement of labor, and regional administration of incentives to attract industry.

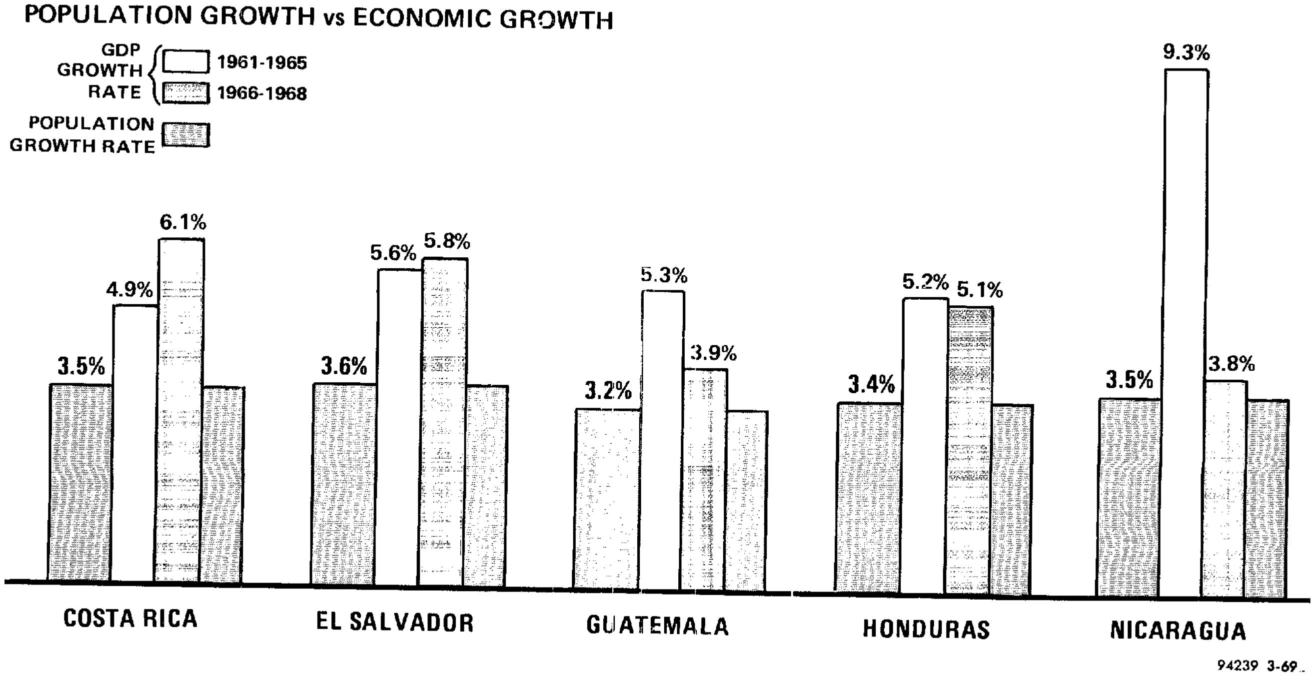
PROSPECTS

The Nicaraguan action was the first major infraction of integration agreements, and because it struck at the heart of the market, and the principle of free intraregional trade, it resulted in the most serious crisis to date. Of course, the road to economic integration cannot be expected to be downhill all the way. Somoza's somewhat impulsive policy of bluster and threat runs the risk of destroying the market, but it has more often succeeded in increasing the pace of integration.

The present crisis has not only pointed out the problems, but has also shown the strengths of the market and the relative maturity of the member states. The Central American leaders were prepared to go to great lengths to avoid a break with Somoza, and instead of unleashing a hysterical propaganda campaign against Nicaragua, they acknowledged the justice of some of Somoza's complaints. Their restraint and the growing pressure from the Nicaraguan business community against any precipitate action was instrumental in tempering Somoza's intransigence. Thus, after holding out for a commitment that existing integrating agreements would be reviewed with an eye to improving Nicaragua's position within the market, he took the heat out of the present crisis.

Although the short-term prognosis regarding the Common Market is cautiously optimistic, until the general principles enunicated in the plan of 21 March are actually translated into workable arrangements and until steps are actually taken to dampen Somoza's discontent, only a tenuous truce will exist. Certainly it would be unrealistic to suggest that the integration movement has become irreversible. The heady days of the early 1960s—when regional integration was regarded as something akin to a magic potion which if swallowed would bring instant development—are gone

POPULATION GROWTH vs ECONOMIC GROWTH



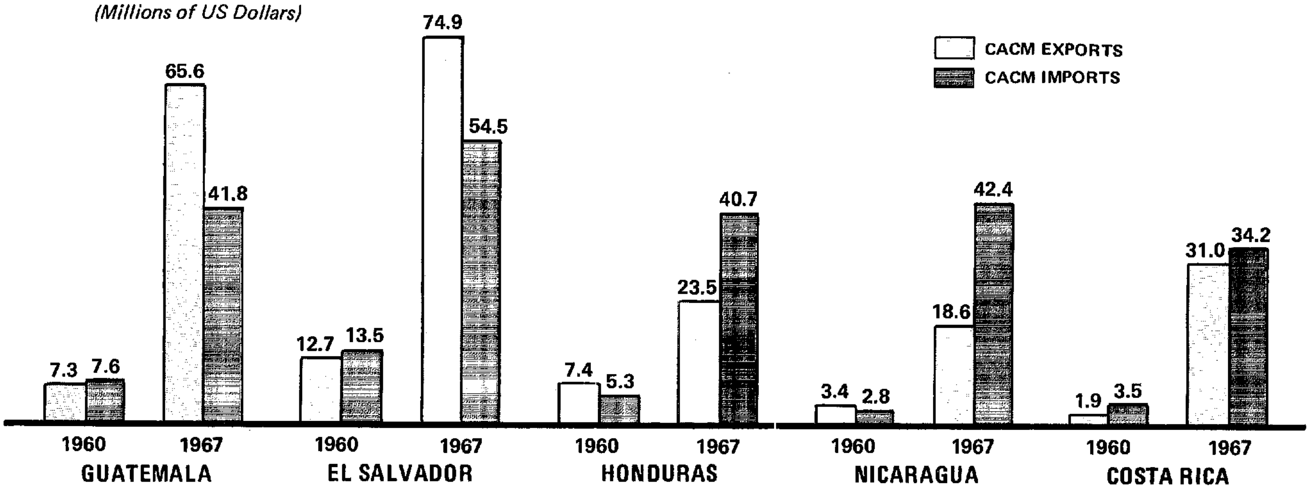
forever. The quick and easy gains of integration (increased intraregional trade, the impetus to industrialization, a step toward import substitution) have already been made, and the rate of future progress will undoubtedly be slower and less dramatic than in the past. The less developed states will continue to insist on favored treatment and the more advanced states will have to consider carefully the degree to which they are willing to divert their own resources to help them.

Negotiation will become more difficult because the issues will tend to involve less of what could be regarded as purely economic questions and become more purely economic in content. This trend is already perceptible. The justifiable pride that accompanied the freeing of intraregional trade has been at least partially diluted by concern over the resultant loss of revenue—and the loss of revenue brings closer the day when politically difficult decisions on tax reform need to be made. The satisfaction over the growth in intraregional trade is tempered by concern over its uneven distribution. Nicaragua, for example, with only 17 percent of the imports and 11 percent of the exports, and a particularly poor showing in manufactured exports, finds it difficult to get excited over the spectacular growth in market trade.

None of the market states is above feathering its own nest at the expense of the others. Consequently, the problems of attracting new industry to the area will not tend to be considered in terms of the "big picture" or the "regional view," but from a more narrow parochial perspective. A prime example has been the insistence of each government on keeping its own petroleum refining industry.

Up to now the policy of import substitution has been highly successful. Here again, however, the very success of the market tends to create political problems. As the area's productive capacity increases, it will become necessary for manufacturers to rely not on protection from imports, but on the increasing purchasing power of local consumers. This would of course entail politically

INTRAREGIONAL TRADE
(Millions of US Dollars)



explosive problems associated with income redistribution. Thus far there is no sign of much improvement in the distribution of income.

Since the inauguration of the Common Market, practically all efforts to accelerate economic development have been focused upon industrialization. The area's severe balance-of-payments difficulties, however, resulting in part from the continued dependence of the Central American economies on a few export crops, will increasingly direct attention to agricultural problems. Any attempt to develop a well-defined regional agricultural program can be expected to bring to the fore a number of new but complicated political issues.

The next few years will be the most critical in the Common Market's history. National leaders will be carefully examining proposals for change with one eye on the domestic political situation and the other on the specific economic advantages to be gained. The present crisis is only a sample of what can be expected in the near future. The most difficult steps have not yet been taken and the most difficult problems have not yet been resolved. Nevertheless, the Central American Market has progressed further than any other economic integration movement outside of Europe; if calmer heads prevail the market may well provide a major impetus to sustained economic growth in the region.

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